IN THE HIGH COURT OF GUJARAT AT AHMEDABAD

INCOME TAX REFERENCE No 57 of 1989

For Approval and Signature:

Hon'ble MR.JUSTICE R.K.ABICHANDANI
and
Hon'ble MR.JUSTICE A.L.DAVE

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1. Whether Reporters of Local Papers may be allowed to see the judgements? : YES

2. To be referred to the Reporter or not? : YES

3. Whether Their Lordships wish to see the fair copy of the judgement? : NO

4. Whether this case involves a substantial question of law as to the interpretation of the Constitution of India, 1950 of any Order made thereunder? : NO

5. Whether it is to be circulated to the concerned Magistrate/Magistrates,Judge/Judges,Tribunal/Tribunals? : NO

COMMISSIONER OF INCOME-TAX

Versus

AHMEDABD ELECTRICITY CO.LTD.

Appearance:

1. INCOME TAX REFERENCE No. 57 of 1989
MR MANISH R BHATT for the Revenue
MR MUKESH M PATEL and Mr.B.P.GUPTA for the Assessee

CORAM : MR.JUSTICE R.K.ABICHANDANI
and
MR.JUSTICE A.L.DAVE

Date of decision: 29/01/2003

ORAL JUDGEMENT

(Per : MR.JUSTICE R.K.ABICHANDANI for the Court)

1. The Income-tax Tribunal, Ahmedabad Bench "A" has referred under Section 256(1) of the Income-tax Act, 1961 the following one question in Reference Application No. 746 of 1988 pertaining to the Assessment Year 1983-84 and two questions in Reference Application No. 751 of 1988 in respect of the Assessment Year 1984-85 at the instance of the Revenue arising from the appeals of the assessee Ahmedabad Electricity Co. Ltd. allowed by it.

"Reference Application No. 746 / Ahd / 1988 A.Y. 1983-84 :

[1] Whether, the Appellate Tribunal is right in law and on facts in accepting the assessee's claim for allowance of bad debts amounting to Rs.47,79,259=00 ?

Reference Application No. 751 / Ahd / 1988 A.Y. 1984-85 :

[1] Whether, the Appellate Tribunal is right in law and on facts in accepting the assessee's claim for allowance of bad debts amounting to Rs.58,70,063=00 ?

[2] Whether, the Appellate Tribunal is right in law and on facts in deleting an amount of Rs.4,43,76,082=00 being the addition made by the I.T.O.?"

2. The assessee - Electricity Company is engaged in the business of generation and supply of electricity to Ahmedabad and Gandhinagar. In the course of assessment proceedings pertaining to A.Y. 1983-84, the assessee put forth a claim in respect of revised bad debts amounting to Rs.49,34,842=00 in its letter dated 5th March 1986. The assessee claimed that the major part of the bad debts related to five textile mills and since the dues were not being paid by them, steps towards recovery were taken by disconnecting the supply of these customers. According to the assessee, these textile mills were in a very poor financial condition and even after disconnection, they did not approach the assessee Company for re-connection which proved that they were unable to resume their business operations. No further legal steps were taken, because, the management perceived that it would amount to spending good money over bad money. According to the

assessee, the chances of recovery were extremely poor. The Income-tax Officer, holding that though the mills were closed, they had considerable assets and further that the liquidation proceedings were not finalised, held that the debt cannot be said to have become bad. The claim for deduction of bad debts was, therefore, disallowed. The C.I.T. (Appeals), while accepting the assessee's claim in respect of the small amount aggregating Rs.1,55,580=00, rejected the balance claim of Rs.1.55,580==00 on the ground that no legal steps were taken in respect of the bad debts, and that the legal proceedings not having been finalised, the debts cannot be treated as irrecoverable while holding that the mills had closed down their business and were declared sick by the government and taken over by the Government of Gujarat vide proclamation issued in the gazette dated 18-11-1985, and that the Company had filed the claims before the Commissioner for payments.

2.1 The Tribunal, took into account several factors including the fact that the assessee was under an honest and a bonafide belief that there was no chance of recovery of the dues which proved to be correct by subsequent events; that the assessee was not trying to derive any revenue gain or benefit by writing off such debt; that the management of the assessee had considered it necessary to write off the bad debts with a view to reflect in the audited accounts the correct state of affairs of the Company's business, as also its assets and liabilities; that considering the financial position of the debtors, it was decided by the management of the assessee not to initiate legal action since that would mean throwing away good money for bad money; that the assessee had disconnected the power supply and none of the parties concerned approached it for restoration of the power supply or any compromise; that most of the defaulters were "sick mills" which were ultimately taken over by the Government of Gujarat and even after the take over, there was no revival and no recovery with the exception of only one party, namely Monogram Mills Co. Ltd., and that such subsequent recovery was offered for tax in the year concerned. The Tribunal held that all the conditions necessary for claim to be allowed were satisfied under Section 36(1)(vii) read with sub-section (2) of section 36 of the said Act. For coming to its decision, the Tribunal relied upon the decision of this Court in Sarangpur Cotton Mfg. Co. Ltd. v. C.I.T., reported in 143 ITR 166, a decision of the Bombay High Court in Jethabhai Hirji v. C.I.T., reported in 120 ITR 792 (Bom.) and Lord's Dairy Farm Ltd. v. C.I.T., reported in 27 ITR 700 (Bom.). The Tribunal, therefore,

directed the I.T.O. to allow necessary relief in respect of the assessee's claim of bad debts after verifying correct figures while observing that the interest of the revenue was duly secured since the subsequent recoveries are subject to tax under Section 41(1) of the Act.

2.2 For the A.Y. 1984-85, the assessee had made a similar claim of bad debts, which were written off to the tune of Rs.58,70,063=00 in respect of the amounts due from the H.T. consumers which became sick units and whose service connections were disconnected. The Tribunal held that its above decision for the A.Y. 1983-84 would apply even in respect of the A.Y. 1984-85. It further stated that the total number of industrial units to which the power supply had been disconnected for these two Assessment Years was sixteen and out of them, only four had revived till the date of the order. The total debt amount of bad debts which were written off and claimed for the two assessment years was to the tune of Rs.1,06,49,323=00 and the recovery subsequently made from some units amounted to Rs.25,23,217=00. There was no recovery in the other twelve units even after a gap of 4 to 6 years. It was observed that the subsequent facts showed that the assessee's claim for deduction ofbad debts was fully justified. The I.T.O. was, therefore, directed to allow the necessary relief after verifying the correct figures.

2.3 In respect of the A.Y. 1984-85, the I.T.O. had made an addition of Rs.4,43,76,082=00 in respect of the electricity duty under Section 43B of the said Act on the ground that the amounts collected by the assessee were in the nature of trading receipt collected by it during the ordinary course of business and therefore, the income which was required to be included in the computation of total income in view of the provisions of Section 28 of the Act. The C.I.T. (Appeals) upheld the said addition by observing that the duty was payable to the government as an overriding charge under Section 4 of the Bombay Electricity Duty Act. The Tribunal held that the assessee Company was only a licensee which was acting on behalf of the State Government for the purpose of collection of electricity duty from the consumers, for which it was getting commission, and that the amount collected was credited in a separate account, which appeared directly in its balance sheet and not in its profit & loss account. The Tribunal found that the amount under consideration was not due for payment to the Government Account till the subsequent assessment year. The Tribunal also referred to the amendment brought into force on 1-4-1988 permitting the deductions of taxes and

duties paid before the filing of the income-tax returns and held that it supported the view that taxes and duties not statutorily payable during the accounting year did not fall to be disallowed under Section 43B of the Act. The Tribunal then held in paragraphs 20 and 21 of its order that, Section 4 of the concerned legislation clearly brought out the difference since in respect of electricity duty the licensee / agent was not liable to pay the duty in cases where it was not able to recover the same from the consumer, and Section 43B was not applicable to the facts of the assessee's case, because, the amount which was sought to be added did not belong to the assessee and was retained by it for a short time as a collecting agent or custodian and subsequently paid over to the government account within the statutory period.

3. The learned counsel appearing for the Revenue contended that non-initiation of legal steps against the debtors goes to show that there was no justification for treating the debt as bad debt and for writing it off for the purpose of claiming deduction. It was submitted that though the mills were closed and being sick mills, were taken over by the government, these mills must be having their assets and until such assets were pursued and recovery attempted therefrom, the dates could not have been declared as bad debts.

3.1 The learned counsel for the assessee, supporting the findings of the Tribunal, argued that the facts established by the assessee and which were not disputed by the revenue clearly indicated that the management of the assessee had, on the basis of an honest judgement on its part, viewed the debt as bad and had actually written it off in its books. He submitted that the material on record convincingly established that there was no reasonable likelihood of any recovery of the debts of the sick undertakings, which came to be taken over by the State Government. He also submitted that recovery action was taken by the assessee by disconnecting the supply of the defaulting debtors and the debts were written off as they did not apply for re-connection and further legal action would have entailed expenditure that would have yielded no results. In support of his contentions, the learned counsel relied upon the decision of this Court in Sarangpur Cotton Mfg. Co. Ltd. v. C.I.T., reported in 143 ITR 166 and decisions of the Bombay High Court in Jethabhai Hirji v. C.I.T., reported in 120 ITR 792 and Lord's Dairy Farm Ltd. v. C.I.T., reported in 27 ITR 700.

3.2 On the second question referred to in respect of

the A.Y. 1984-85, the learned counsel for the Revenue argued that, though the first proviso inserted in Section 43B w.e.f. 1-4-1988 is held to be retrospective in operation by the Supreme Court in Allied Motors (P) Ltd. v. C.I.T., reported in 224 ITR 677, and therefore, if the amounts were paid by the due date mentioned in that proviso, the addition may not be sustained, the reasoning given by the Tribunal that the assessee - Electricity Company as a collecting agent was in no way liable to pay the duty to the government, was not warranted by the provisions of the Act. The learned counsel for the assessee, however, supported the claim mainly on the basis of the decision of the Supreme Court in Allied Motors (supra) for contending that the addition was not justified since the amount was paid by the due date.

4. The first question, which is common in respect of both the Assessment Years, raises a controversy, whether the debt in question had become a bad debt, and whether the deduction was admissible on the ground that it was validly written off as a bad debt in context of the provisions of Section 36(1)(vii) and sub-section (2) of section 36 of the Act, which are re-produced hereunder :

"36. Other deductions :

(1) The deductions provided for in the following clauses shall be allowed in respect of the matters dealt with therein, in computing the income referred to in section 28 -

xxxxx

xxxxx

(vii) subject to theprovisions of sub-section (2), the amount of any debt, or part thereof, which is established to have become a bad debt in the previous year;

xxxxx

xxxxx

(2) In making any deduction for a bad debt or part thereof, the following provisions shall apply :-

(i) no such deduction shall be allowed unless

such debt or part thereof -

(a) has been taken into account in computing the income of the assessee of that previous year or of an earlier previous year, or represents money lent in the ordinary course of the business of banking or money-lending which is carried on by the assessee, and

(b) has been written off as irrecoverable in the accounts of the assessee for that previous year;

xxxxx

xxxxx "

5. The question of bad debts would arise when while following the method of accountancy on accrual basis, the income is shown in any previous year, but the real income is not likely to be received due to the default of the debtor or reasons beyond the control of the creditor. Bad debt is the account receivable that is likely to remain uncollectible and is written off. If the assessee arrives at a bonafide conclusion that the amount so established would not be collected, the amount of receivables must be reduced to reflect that accounting event. The management of commercial entities have full authority to decide when certain accounts receivable are considered as uncollectible. The write off means to charge an asset amount to expense or loss in order to reduce the value of that asset and one's earning.

5.1 A debt must be both bad and actually written off before any deduction can be claimed under Section 36(1)(vii) read with section 36(2). Whether or not a debt is bad is a question to be determined objectively, and not by subjective opinion of any particular individual. The objective test in deciding whether a debt is bad or not is whether a reasonable prudent business person would conclude that there is no reasonable likelihood that the debt will be paid by the debtor or someone else either on behalf of the debtor or otherwise. The debt in question must be "bad" to be written off as irrecoverable in terms of section 36(2)(b) of the Act. This is essentially a question of fact. However, a debtor does not need to be insolvent for the debt to be bad. It is sufficient, if on a bonafide assessment, the debtor is unlikely to make the payment of the debt. The objective test is that, on the balance of

probabilities, the circumstances must indicate to a reasonable and prudent business person that the debt is unlikely to be recovered. Merely because legal steps for recovery are not taken, it cannot in such a case be inferred that the debt is not bad.

5.2 The relevant factors that can enable forming of the view that there is no reasonable likelihood that the debt will be paid are:

(i) the length of time the debt is outstanding - the longer the debt is outstanding, the more likely it will be considered to be bad debt by a prudent business person,

(ii) the efforts that a creditor has taken to collect a debt - the greater the extent to which a person has unsuccessfully tried to collect the debt, the more likely will it be considered to be bad by a prudent business person, and

(iii) information about the debtor a creditor may have obtained reliable information about the debtor, such as, financial difficulties and defaults of the debtor towards other customers or insolvency, that would lead a prudent business person to conclude that a debt is bad.

5.3 A debt can be considered bad on the occurance of any of the following events :

(i) That death of the debtor without leaving any assets from which the debt could be recovered;

(ii) The debtor is a bankrupt or in liquidation and there are no assets from which the debt can be recovered in forseeable future;

(iii) The debt is statute barred;

(iv) The debtor is not traceable despite various attempts and there are no known assets from which the debt can be recovered;

(v) Attempts at negotiation or arbitration of a disputed debt have failed and anticipated cost of litigation is prohibitive; or

(vi) There exists any other circumstances where there is no likelihood of a cost effective recovery of the debt.

6. In most of the cases, a tax-payer's considered opinion that a debt is a bad debt should suffice, when there are circumstances or material to indicate the reasonableness of the decision to treat the debt as bad. The nature of information required to decide whether a debt is bad would depend on the particular circumstances of each case. In final analysis, however, the test would be whether the tax-payer had sufficient information to reasonably conclude that there was no reasonable likelihood that the debt will be paid, even if further or any recovery actions were to be taken. In some cases, the creditor may take no or only limited recovery action, because, enough information is received to form a reasonable view that the debt is bad.

6.1 A creditor is likely to have taken recovery action in most cases before a deduction for a bad debt is claimed, although it is not a requirement that such action be taken before a decision is made that a debt is bad. However, it is through taking recovery action that most creditors will form an opinion as to whether the debt is bad. The decision to take recovery action and the extent of that action will depend on the circumstances of each case. A creditor may take recovery action even when he believes that there is no reasonable likelihood of the debt being paid for a number of reasons, for example, when the creditor adopts a policy of pursuing debtors to a certain extent to discourage its customers from committing similar defaults. Even while taking recovery action, a debt can be construed bad to the extent that a prudent business person would consider that there is no reasonable likelihood that the debt will be paid.

7. To support a claim for deduction of a bad debt written off for tax purposes, there should be sufficient evidence to show that reasonable steps based on sound commercial considerations were taken to recover the debt. Such steps would include one or more of the following steps :

(a) Issuing reminder notices;

(b) re-structuring of debt;

(c) re-scheduling of debt settlement

(d) negotiation or arbitration of a disputed debt; and

(e) legal action.

7.1 The decision not to take legal action should be considered to be reasonable if it can be shown that the anticipated cost of any legal action is prohibitive in relation to the amount of the debt.

8. For claiming deduction, it is not enough that a debt is bad. The bad debt must also be actually written off. Writing off the bad debt is important, because, that will fix the time at which the deduction can be made. A debt does not become a deductible debt, if and when it becomes a bad debt. It becomes deductible if it has been incurred in the production of assessable income, when it is written off. In other words, the crucial time when a debt becomes deductible is the time of writing off, not the time the debt becomes a bad debt.

8.1 Necessary book-keeping steps must be taken to record that the debt has been written off. It is not possible to write off a debt as bad without making authorised journal entries in the books of account of the business which would clearly show that the debt has been actually written off as bad. If the creditor ceases to recognise the debt as an asset for accounting purposes by removing it from the accounting base records, it is written off. No matter what form a tax-payer's books of account or accounting records may take, those existing in respect of a bad debt owed by a bad debtor must record that the tax-payer or an authorised person on behalf of the tax-payer, having decided the debt as bad, has written off the debt accordingly.

8.2 The writing off a trade debt as bad requires judgement on the part of the person carrying on the business taking into consideration all circumstances of the debt as to the likelihood and cost of its recovery before a decision is taken to write off the debt. The tax-payer has to establish that the circumstances were such that they would indicate to a reasonable and prudent business person that the debt was unlikely to be recovered. For bad debt to be properly written off, it must be bonafidely written off. The evidence should establish that, notwithstanding the fact that the tax-payer might have some hope for some future recovery of some part of the indebtedness, there was good reason to believe at the time of writing off future recovery of some part of the indebtedness that it was unlikely to be recovered.

9. The facts found by the Tribunal in these cases

clearly indicate that the bad debts related to the textile mills which had fallen sick and were unable to discharge their liabilities. These mills were admittedly taken over under the provisions of the Gujarat Closed Textile Undertakings (Nationalisation) Act, 1986. Chapter II of that Act provides for acquisition of the rights of owners of specified textile undertakings. As provided in section 3(1) of the said Act, on the appointed day, every specified textile undertaking and the right, title and interest of the owner in relation to very such textile undertaking stood transferred to, and vested absolutely in, the State Government. All these debtors - mills are specified at Srl. No. 1, 2, 3 and 6 of the First Schedule. As per sub-section (2) of section 3, these undertakings which vested in the State Government, stood transferred immediately thereafter to and vested in the Gujarat State Textile Corporation Ltd. Under Section 4(2), it is provided that all property which had vested in the State Government under sub-section (1) of section 3, "shall, by force of such vesting, be freed and discharged from any trust, obligation, mortgage, charge, lien, and all other encumbrances affecting it, and any attachment, injunction or decree or order of any Court restricting the use of such property in any manner shall be deemed to have been withdrawn."

9.1 The record also indicates that the assessee Electricity Company had disconnected electricity supply of these debtors. Under section 24 of the Indian Electricity Act, 1910, it has been provided that, "where any person neglects to pay any charge for energy or any sum, other than the charge for energy, due from him to a licensee in respect of the supply of energy to him, the licensee may, after giving not less than seven clear days' notice in writing to such person and without prejudice to his right to recover such charge or other sum by suit, cut of the supply and for that purpose, cut or disconnect any electric supply - line or other works, being the property of the licensee, through which energy may be supplied, and may discontinue the supply until such charge or other sum, together with any expenses incurred by him in cutting off and re-connecting the supply, are paid, but no longer." Thus, one of the way statutorily provided for effecting recovery of the dues was of discontinuance of the supply to the consumers. The assessee - Electricity Company did take such coercive measure of disconnecting the supply of electricity in accordance with the provisions of section 24 of the Indian Electricity Act, 1910 for effecting the recovery. The fact that the debtors did not move the Company for

restoring the supply by paying the dues indicates that there was no likelihood of recovering the dues of these debtors whose assets had vested in the State Government free from all encumbrances since these textile undertakings were taken over as per the provisions of the Gujarat Closed Textile Undertakings (Nationalisation) Act, 1986. There were, therefore, no assets from which the assessee company could have effected recovery of the dues in any forcible manner. In the facts and circumstances of the case, which are not in dispute, the management of the assessee took a decision not to spend good money over bad money by attempting any further legal remedies against these dead undertakings, whose assets had vested in the State Government free from all encumbrances.

9.2 In the above view of the matter, we find that the Tribunal, on the basis of aspects which it has highlighted in paragraphs 5, 11 and 12 to 14 of its order, was right in accepting the assessee's claim for allowance of bad debts amounting to Rs.47,79,259=00 in respect of the A.Y. 1983-84 and Rs.58,70,063=00 in respect of the A.Y. 1984-85. The question No.1 in respect of both the two Assessment Years is, therefore, answered in the affirmative against the Revenue and in favour of the assessee.

10. As regards the question No.2 for the A.Y. 1984-85, we may first deal with the finding of the Tribunal in paragraphs 20 and 21 of its order that, in view of Section 4 of the Bombay Electricity Duty Act, 1958, the assessee was not liable to pay electricity duty to the State Government being only a licensee, and that Section 43B was not applicable on the ground that the amount of duty received by the assessee did not belong to the assessee, but was retained for a short time as a collecting agent.

10.1 Under section 4(1) of the Bombay Electricity Duty Act, 1958, every licensee shall collect and pay to the government at the time and in the manner prescribed the proper electricity duty payable under the Act in respect of energy supplied by him to consumers. The duty so payable shall be a first charge on the amount recoverable by the licensee for the energy supplied by him and shall be a debt due by him to the State Government. As per the proviso to sub-section (1) of Section 4, where the licensee has been unable to recover his dues for the energy supplied by him, he shall not be liable to pay the duty in respect of the energy so supplied. It is, thus, the obligation of the licensee to pay electricity duty to

the government in respect of energy supplied by the licensee to the consumers unless the licensee is unable to recover the dues for the energy supplied by it. If the licensee recovers his dues, but does not recover the amount of duty, in that event, the duty will be a first charge on the amount recovered by the licensee for the energy supplied. The provisions regarding recovery made under Section 8 make it clear that if the sum due on account of electricity duty was payable under sub-section (1) of section 4, the sum together with interest thereon shall be recoverable either through civil court or as an arrear of land revenue from the consumer, or subject to the proviso to sub-section (1) of section 4, from the licensee at the option of the State Government. Therefore, in cases where the proviso to section 4(1) is not attracted and the licensee cannot be said to have been unable to recover the dues for energy supplied by the licensee, the licensee can, at the option of the State Government, be proceeded against for the recovery of the electricity duty under Section 8(a) of the Act. In view of the clear liability of a licensee who has recovered the charges for the electricity supplied, it cannot be said that a licensee being an agent is not liable to pay the electricity duty to the State Government. He would not be liable to pay the duty only if he is unable to recover his dues for the energy supplied by him. These provisions obviously have a bearing on the actual recovery of the dues and would not instantly apply when the accounting is kept on accrual basis, because, at the time of accrual entry, the question of being unable to recover the dues at that very moment cannot arise. We, therefore, cannot subscribe to the observations of the Tribunal that Section 43B would not be applicable applicable to the assessee's case on the ground that the electricity duty recovered by it did not belong to it, but it was retained for a short time, as a agent of the government. The amendment inserting the first proviso to Section 43B was brought about by the Finance Act, 1987 inserted w.e.f. 1-4-1988, is held to be having a retrospective effect, as per the decision in Allied Motor's case (supra). The Tribunal has referred to this proviso in paragraph 22 of its order. Therefore, the deletion of the addition made by the I.T.O. covered by question No.2 was justified under the said proviso, which had a retrospective effect, if the duty is actually paid by the due date envisaged under the said proviso to Section 43B. In the above view of the matter, the question NO.2 which is referred to in respect of the A.Y. 1984-85 is answered in the affirmative, for the reasons that we have indicated hereinabove, against the Revenue and in favour of the assessee.

The Reference stands disposed of accordingly. There shall be no order as to costs.

[R.K.ABICHANDANI, J.]

[A.L.DAVE, J.]

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